

# Planning for 2011 and beyond\*



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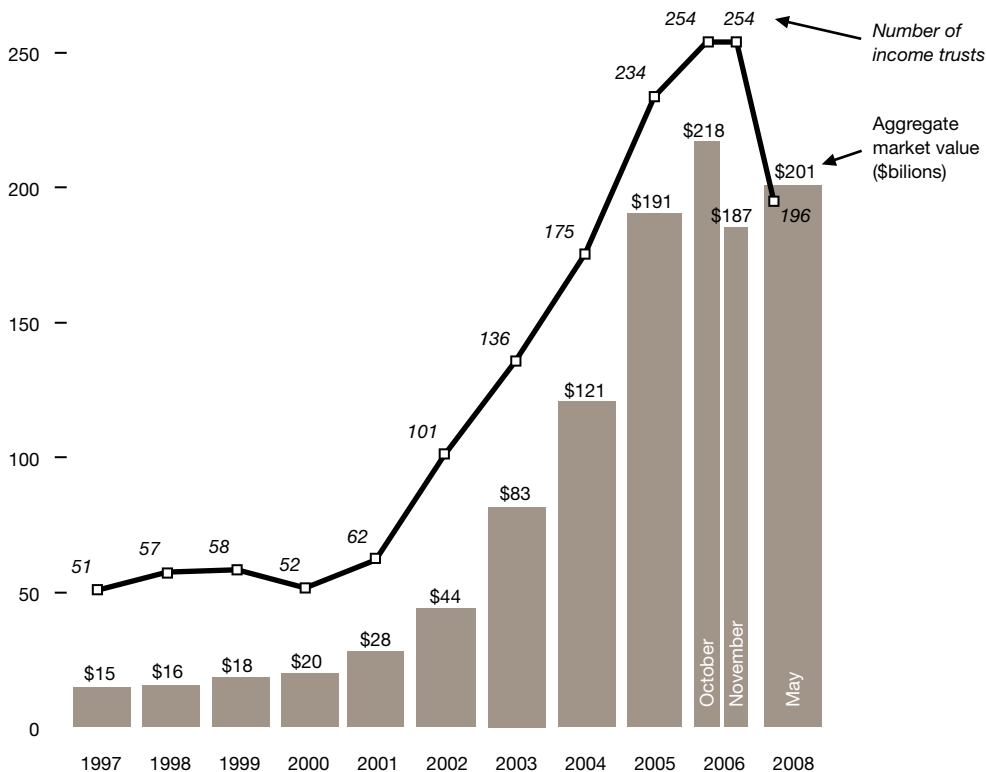
# Introduction

Income trusts' wave of expansion and ready access to capital came to an abrupt end on October 31, 2006, when Finance Minister Jim Flaherty announced a tax on publicly listed income trusts and limited partnerships (to be known as specified investment flow-through [SIFT] entities). The impact of this announcement on the income trust market was swift and dramatic, as illustrated in the chart below. Since then, many income trust investors and managers have been trying to evaluate their options and determine their best course of action.

This publication is designed to help investors and managers with this decision-making process by summarizing the key business, strategic and tax issues facing income trusts and the advantages and disadvantages of various options.

Trustees and management should be aware that any transaction will require substantial planning, organization and thought. In light of the required resources, it is important that decisions are not made quickly or without full consideration of all of the issues.

To help trustees and management consider the issues raised in this publication, they should seek the advice of a professional services advisor with strong experience in income trust formation, privatizations, insolvency and financing. PricewaterhouseCoopers has a number of professionals with experience in these areas. For further information on the services we provide, please refer to the How We Can Help section at the end of this publication.



Looking for background information on the income trust tax policy issues? Visit [www.pwc.com/ca/incometrusts](http://www.pwc.com/ca/incometrusts) for a comprehensive report, dated December 11, 2006, which analyzed a number of economic and tax policy issues related to income trusts. On this webpage, you will also find detailed *Tax Memos* which outline how the SIFT tax is to be applied.

# The Trust Market Today

The trust sector has a current market capitalization of approximately \$201 billion, accounting for approximately 10% of the TSX. The aggregate number of trusts now stands at 196. Before the October 31, 2006 announcement, the number of trusts stood at 254.

## Market capitalization by sector

	May 2008		October 2006		% Change	
	Count	Market cap. (\$ mm)	Count	Market cap. (\$ mm)	Count	Market cap.
Business	131	79,239	173	95,493	-24%	-17%
Pipeline & power	16	15,180	23	20,156	-30%	-25%
Oil & gas royalty	24	83,054	31	76,216	-23%	9%
REITS	25	23,271	27	26,440	-7%	-12%
<b>Total</b>	<b>196</b>	<b>200,744</b>	<b>254</b>	<b>218,305</b>	<b>-23%</b>	<b>-8%</b>

Source: TD Newcrest – Income Trust Score Sheet, May 2008

This drop is largely the result of a high number of trust M&A transactions that occurred in the twelve months following the announced changes in trust taxation. Interestingly, half of these transactions involved foreign buyers, reinforcing concerns surrounding the “hollowing out” of the Canadian corporate sector. However, trust sector M&A activity has since slowed dramatically, largely as a result of weaker credit markets that emerged in the fall of 2007.

## M&A activity November '06 to October '07

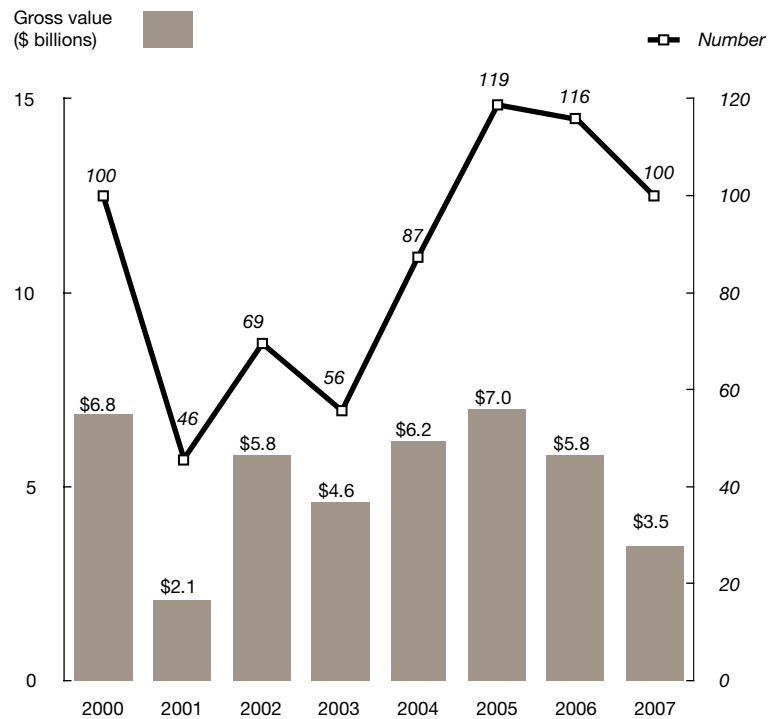
	Strategic buyer		Private equity		Total
	Domestic	Foreign	Domestic	Foreign	
Business	5	6	6	8	25
Pipeline & power	2	0	0	2	4
Oil & gas royalty	3	0	1	2	6
REITS	2	2	1	0	5
<b>Total</b>	<b>12</b>	<b>8</b>	<b>8</b>	<b>12</b>	<b>40</b>

Source: PricewaterhouseCoopers

Introduction of the SIFT tax appears to have had a significant effect on the IPO market. During the period from 2000 to 2006, IPO activity was fuelled by the creation of new income funds to satisfy the demand of the market for high-yield securities. Following the SIFT tax announcement, gross proceeds from IPOs in 2007 declined to their lowest level since 2001.

Despite the predictions of several industry analysts, the SIFT tax has not resulted in a significant increase in the number of Canadian high-yield debt offerings.

### Gross Value and Number of IPOs on Canadian Exchanges



PricewaterhouseCoopers IPO Survey

# Key Business Issues to Consider

Not all trusts are the same. They come in a variety of sizes and industries. Their balance sheets vary from no debt to relatively high levels of debt. Some are purely domestic; others operate internationally. Even though most trusts still make large cash distributions, there is a variety of payout ratios. As a result, the SIFT tax will affect some more than others.

Despite their differences, all trusts must now address these key business issues:

- sustainability of distributions;
- optimal capital structure;
- access to capital;
- equity valuation; and
- governance and financial reporting.

## Snapshot of Trust Sector (May 2008)

	Count	Market cap. (\$mm)	EV ÷ EBITDA	Net debt ÷ EBITDA	Payout ratio	Run rate yield
<b>Business trusts</b>						
Energy equipment & services	17	8,468	9.3 x	2.5 x	90%	15.2%
Materials	16	18,554	13.4 x	2.1 x	86%	12.4%
Industrials	34	11,468	6.8 x	1.5 x	84%	12.8%
Consumer discretionary	28	13,829	7.6 x	1.7 x	83%	15.2%
Consumer staples	14	2,385	9.4 x	3.0 x	n/a	11.2%
Healthcare	3	1,815	10.3 x	1.4 x	80%	8.9%
Financials	13	10,867	8.4 x	1.3 x	88%	12.4%
Information technology	3	1,785	6.9 x	1.2 x	70%	12.0%
Telecommunication services	1	6,624	6.5 x	1.9 x	93%	10.0%
Utilities	2	3,444	7.3 x	1.2 x	77%	8.1%
	131	79,239				
<b>Power &amp; pipeline</b>						
Pipeline	6	9,723	10.5 x	3.9 x	84%	8.3%
Power	10	5,457	10.2 x	3.4 x	n/a	10.8%
	16	15,180				
<b>Oil &amp; gas trusts</b>			EV ÷ DACF <sup>(1)</sup>	Net debt ÷ cash flow	Payout ratio	Cash yield
Oil & gas trusts	24	83,054	7.9 x	1.7 x	69%	12.0%
<b>REITS</b>			P ÷ FFO <sup>(2)</sup>	P ÷ AFFO <sup>(3)</sup>	AFFO payout ratio	Run rate yield
Commercial	15	16,347	10.9 x	14.5 x	95%	8.2%
Hotel	3	1,001	8.7 x	11.7 x	104%	11.8%
Multi-residential	4	4,096	22.7 x	18.8 x	141%	7.1%
Senior housing	2	1,703	12.2 x	11.6 x	102%	9.2%
Self-storage	1	124	12.9 x	12.6 x	149%	11.8%
	25	23,271				
<b>Grand Total</b>	<b>196</b>	<b>200,744</b>				

1 "DACF" Debt adjusted cash flow

2 "FFO" Funds from operations

3 "AFFO" Adjusted funds from operations

Source: TD Newcrest – Income Trust Score Sheet, May 2008

## Sustainability of Distributions

At least at inception, a key benefit of the choice of a trust structure was to make cash distributions of income in the most tax-effective manner. Some people have said that the trusts were tax-exempt. This is inaccurate, because trusts are subject to a top marginal personal tax rate (ranging from 39% to 48%, depending upon the province or territory of residence). This tax was avoided only by distributing income to the trust's unitholders where the income was subject to tax depending upon the nature of the unitholder (e.g. Canadian individual, corporation, pension fund, non-resident, etc.).

The only feature that made a trust more tax efficient was that it eliminated the double taxation of income that had been inherent in Canada's corporate income tax system. By double taxation, we mean that corporate income was taxed both as it was earned and when it was distributed as dividends. The effect of this double taxation has been reduced somewhat with recent increases in the personal dividend tax credit.

Aside from the tax efficiency of a trust structure, many investors were particularly attracted to the promise of a high-yield cash-paying investment.

Stung by large corporate scandals or unsuccessful attempts at diversification, many investors wanted simple cash-generating businesses in which to invest. Many trusts met that objective and continue to do so. Others, however, were subject to business cyclicalities and the same management issues faced by corporations. Some may have been caught by overly-aggressive estimates of distributable cash. Many of those trusts had to cut or suspend distributions.

Payout ratios now typically range between 80% and 90% across the trust universe (see chart on previous page). At these levels the trust units appear particularly vulnerable to a broad-based economic slowdown. However, this risk is not unique to trusts, and several trusts continue to benefit from strong commodity prices.

A trust today still faces the same basic questions that it dealt with on formation: What level of cash distribution should be made to the equity holder and how much should be reinvested in the business? These are simple questions with complex answers that look to the need for capital for expansion and the optimal capital structure for the business.

As a first step, we recommend that at a minimum every trust understand how the SIFT tax will affect its operating cash flow and whether the current level of distributions can be sustained after 2010.

## Example: Three Distinct Trusts

Consider the example of three distinct trusts (A, B and C) with different types of income distributions. The example is based on the following assumptions:

- Before implementation of the SIFT tax, the trust distributes \$950 or 95% of its \$1,000 distributable cash. Distributions after implementation of the SIFT tax are assumed to be reduced by the amount of the SIFT tax.
- The 29.5% SIFT tax rate reflects a 16.5% federal component (declining to 15% by 2012) and a 13% provincial component. In fact, the provincial component will vary depending upon the actual provincial corporate tax rates in provinces in which the SIFT maintains a permanent establishment.
- Personal tax rates of 46% and 24% are assumed to apply to trust income and eligible dividends respectively. These personal tax rates vary by province of residence.

## The Effect of the SIFT Tax on Different Investors

These calculations demonstrate several points regarding the potential effect of the SIFT tax on cash distributions:

### 1) Trusts that operate in Canada will face distribution reductions.

A trust that currently distributes most of its income and operates mainly in Canada will likely face distribution reductions (i.e., cash that would have gone to investors will now have to be held back in order to pay the SIFT tax). However, an individual taxable investor should be no worse off after-tax, because the Canadian source portion of his or her distribution will be taxed as a dividend eligible for the dividend tax credit.

Given the reaction to the SIFT tax by the markets to date, it appears that the markets do not fully consider tax issues. Or, at least, it appears that exempt or non-resident investors have more influence on the market price than taxable individual investors. If the level of the distribution is the only driver of market valuation, then unit values will drop. On the other hand, the valuation model may slowly evolve to a corporate earnings model instead of a capitalized distributions model.

## Three types of trusts: effect on different investors

		Trust		
		A	B	C
Source of income	Canadian	100%	80%	20%
	Foreign	-	-	80%
	Return of capital	-	20%	-
Distributions	Distributable Cash	1,000	1,000	1,000
	Payout ratio	95%	95%	95%
	Subtotal	950	950	950
	Distributed as:			
	Return of capital	-	190	-
	Non-portfolio earnings	950	760	190
	Foreign source income	-	-	760
	<b>Cash available for distribution (before SIFT tax)</b>	<b>950</b>	<b>950</b>	<b>950</b>
SIFT Tax Calculation	Non-deductible distributions	670	536	134
	Gross-up factor = 100% / (100% - 29.5%)	141.8%	141.8%	141.8%
	Taxable SIFT distributions	950	760	190
	SIFT tax rate	29.5%	29.5%	29.5%
	<b>SIFT Tax payable</b>	<b>280</b>	<b>224</b>	<b>56</b>
1. Individual taxable investor	<b>No SIFT Tax</b>			
	Canadian source income	950	760	190
	Foreign source income	-	-	760
	Taxable trust distribution	950	760	950
	46% personal tax	(437)	(350)	(437)
		513	410	513
	Return of capital	-	190	-
	<b>After-tax cash to investor</b>	<b>513</b>	<b>600</b>	<b>513</b>
	<b>With SIFT Tax</b>			
	Taxable dividends	670	536	134
	24% personal tax	(160)	(128)	(32)
		509	407	102
	Foreign source income	-	-	760
	46% personal tax	-	-	(350)
	-	-	410	
Return of capital	-	190	-	
<b>After-tax cash to investor</b>	<b>509</b>	<b>597</b>	<b>512</b>	
<b>Loss of cashflow from SIFT tax regime</b>	<b>4</b>	<b>3</b>	<b>1</b>	

## 2) Tax-exempt investors will be most seriously affected by the SIFT tax.

The SIFT tax will affect tax-exempt investors (e.g., pension funds and RRSPs) essentially because they are not eligible for a dividend tax credit. In fact, income allocated to exempt investors will still be double-taxed, once as earned by the SIFT and again as distributed to the beneficiaries (e.g., as personal pension income). Many commentators, including PwC, have suggested that the government consider a form of refundable dividend tax credit for pension funds.

## 3) Large tax-exempt investors can avoid the SIFT tax by creating private trust or partnership structures.

A privatization of an existing SIFT by a pension fund investor offers considerable tax advantages. While the loss of corporate tax revenues resulting from the possible conversion of BCE into a trust is often mentioned as a key reason for the introduction of the SIFT tax, the subsequent privatization of BCE, if and when completed, will also significantly reduce corporate tax revenues. It appears that pension funds have successfully maintained a tax advantage over taxable and retail investors.

## 4) Non-resident investors also appear to be worse off.

However the analysis is not complete, because it does not consider tax payable in the investor's country of residence. The effect of the SIFT tax is to increase Canada's share of the overall tax, which may be viewed as reasonable when the income is from a Canadian source.

## Three types of trusts: effect on different investors

		Trust		
		A	B	C
<b>2.</b> Tax-exempt investor	<b>No SIFT Tax</b>			
	Net taxable trust distribution	950	760	950
	Return of capital	-	190	-
	<b>After-tax cash to investor</b>	<b>950</b>	<b>950</b>	<b>950</b>
	<b>With SIFT Tax</b>			
	Taxable dividend	670	536	134
	Foreign source income	-	-	760
	Return of capital	-	190	-
	<b>After-tax cash to investor</b>	<b>670</b>	<b>726</b>	<b>894</b>
	<b>Loss of cashflow from SIFT tax regime</b>	<b>280</b>	<b>224</b>	<b>56</b>
<b>3.</b> Non-resident investor	<b>No SIFT Tax</b>			
	Trust distribution	950	950	950
	15% withholding tax	(143)	(143)	(143)
	<b>Net distribution to investor</b>	<b>807</b>	<b>807</b>	<b>807</b>
	<b>With SIFT Tax</b>			
	Trust distribution	670	726	894
	15% tax	(100)	(109)	(134)
	<b>Net distribution to investor</b>	<b>570</b>	<b>617</b>	<b>760</b>
	<b>Loss of cashflow from SIFT tax regime</b>	<b>237</b>	<b>190</b>	<b>47</b>

## 5) Trusts with mostly foreign source income are not subject to the SIFT tax.

Distributions of foreign source income are not subject to the SIFT tax, so the trust structure may continue to be most optimal for these trusts. Trusts that operate both in Canada and abroad should ensure that any foreign source income retains its character as it flows to the trust. For example, some restructuring may be necessary to ensure that foreign-source income earned by a subsidiary corporation does not become re-characterized as Canadian interest paid on debt between the trust and the Canadian parent corporation.

## 6) Trusts that distribute cash mainly as a return of capital may not be immediately affected by the SIFT tax.

Typically, these are trusts with high levels of tax shelter (e.g., resource deductions) in capital intensive industries. The tax shelter offsets income and cash flow can be distributed as a return of capital. Presumably, over time the level of income distributions would increase.

## 7) The SIFT tax is not 29.5% of income distributions.

In fact, the calculation is as follows:

Non-deductible distribution amount	\$1,000
	$\div (100\% - 29.5\%)$
Taxable SIFT trust distributions	1,418
	$\times 29.5\%$
Tax payable	<b>\$418</b>

The 29.5% applies to a grossed-up amount, so that the actual distribution is akin to an after-tax corporate dividend. SIFTs will have to ensure that, as a consequence of the circularity of the calculation, they retain adequate cash to fund the SIFT tax.

These seven points demonstrate that before considering alternatives, trusts must assess how they will be affected by the SIFT tax. Many have already announced whether the level of distributions will be affected.

## Optimal Capital Structure

From a leverage perspective, the trust universe now appears moderately leveraged with Net Debt / EBITDA levels ranging between 1.0x to 2.0x (power and pipeline trusts excluded). It appears that, overall, the trust sector is capitalized in a manner that should help sustain debt covenants through economic downturns. In addition, the moderate leverage levels across the trust universe suggest that many trusts may successfully avoid the need to raise capital in less than receptive equity and debt markets.

However, despite what may appear to be a moderate level of debt, there is no doubt that leverage in combination with a high payout ratio adds considerable risk to the sustainability of distributions. Examples abound of lenders forcing a suspension of distributions following debt covenant violations. Because market valuation is so closely tied to the level of distributions, unit valuations typically drop dramatically.

It is worth stating again that cyclical businesses are not well suited to either a trust model or a corporate model with high levels of distributions or dividends relative to cash flow. Investors must understand that trust distributions, just like corporate dividends, are returns on equity investments that carry risk. Investors would be mistaken to treat such investments as “debt-like.”

## Access to Capital

A key business issue for investors and income trust managers is access to capital. Businesses require capital to expand, and the trust market was a good source of capital for mid-market Canadian companies. Many trusts have used that capital to expand domestically and internationally. In that respect, the income trust market was a huge success by anyone’s standards. By effectively destroying the trust market without any immediate form of replacement, the federal government created a significant problem for trusts requiring capital to expand. The cost of capital has increased even for those able to access capital.

Since October 2006, secondary issuances of trust units have declined dramatically and it is practically impossible to issue trust units as partial consideration on the acquisition of a business. Some trusts have issued high-yield, subordinated debt, but that market is still limited in size.

Trusts that need capital (to either expand or refinance) may have to look to foreign sources or private domestic sources. Concerns include not exceeding the SIFT growth limitations and maintaining majority Canadian ownership, as required under the mutual fund trust tax rules.

Faced with these issues, some trusts have decided to convert back into a corporate form. Others have decided to privatize by initiating a sale process.

## Equity Valuation

At one time, trusts were afforded a valuation premium over corporations. This resulted from the fact that trusts tended to be valued based on a capitalization of distributions as opposed to an earnings model. Some might argue that the yields applied to trust distributions were too low and not fully reflective of risk. As a consequence, trust unit valuations were highly susceptible to changes in the level of distributions.

The introduction of the SIFT tax reduced market valuations reflecting the possible impact on distributions starting in 2011. The size of that “tax-driven” discount may increase as 2011 draws nearer. On the other hand, the valuation model may move more in line with a corporate valuation model.

In our view, the valuation premium given to trusts over comparable public companies structured as corporations has eroded since the SIFT tax announcement. In fact, many smaller individual trusts now carry valuations that reflect a decline in research coverage and institutional investor following. These trusts could struggle to raise capital in the near-term and may well initiate a sale process before 2011, likely once the M&A markets show signs of a sustained improvement.

## Governance and Reporting

Many boards of directors, audit committee members and senior management teams of income trusts will recall the often complex structures, significant tax implications and unique accounting and financial reporting issues associated with

their original IPO, conversion or carve-out transactions. These transactions required substantial planning, organization, thought and the assistance of various professionals to clarify the objectives of the plan to become a trust.

Similar processes will have to be given consideration again in respect of the various alternatives raised in this discussion paper. Costs are likely to be comparable to the completion of another IPO, conversion or carve-out transaction. Planning the course for conversion back to a corporation (if that is the right route) may trigger numerous new and complex tax, financial reporting and accounting issues, reinforcing the importance of a plan that contemplates the alternatives and their consequences.

Clearly, it is important that trust management review and evaluate all of the matters raised in this discussion paper. It is also important to plan for the timely involvement of the board of directors and audit committee members in the issues, risks, alternatives, costs and timetable for the conversion plan. These issues can have significant and varying effects on the various unitholders of the trust. As a result, the board of directors should evaluate those implications to determine the right course of action for each trust.

International Financial Reporting Standards (IFRS) are affecting all public reporting entities on January 1, 2011—the same date the SIFT tax takes hold for income trusts. Income trust management and their boards may have dual challenges to face in dealing with

the development and management of their IFRS conversion plan in conjunction with the significant challenge of managing the alternatives as a result of the implementation of the SIFT tax.

Many income trust managers have already experienced the challenges and constraints associated with having to account for future income taxes with the legislation being substantially enacted for their quarters on and after June 30, 2007. They will face further financial reporting and accounting challenges with the introduction of current income taxes after January 1, 2011, as well as the significant and complex issues that will arise through their conversions using many of the alternatives suggested in this publication.

New and unforeseen accounting and financial reporting issues that may arise as a result of conversion plans likely will have no immediate solutions. Therefore, it is imperative that income trusts consider and evaluate the available alternatives, with a view to having solutions in hand before the deadlines for completion.

While the dual tasks of evaluating each of the options available to the trusts, in conjunction with implementing International Financial Reporting Standards may seem daunting, trust managers can reduce the stress and cost of these activities by developing plans that are efficient and give due consideration to the implications and significance of each of these enterprise-wide changes. Now is the time to start the planning process on both fronts to ensure that adequate consideration, time and resources are available to meet these deadlines.

# Evaluating the Options

Income trust investors and managers have a variety of options. The high level of M&A activity in 2007 suggests that many businesses, perhaps driven by the need to access capital, have decided to move away from the public trust structure.

All remaining trusts need to evaluate their options and consider the advantages and disadvantages of each opportunity depending on their financial situation and strategic business objectives.

## 1. Status Quo

Why not just stay as a trust? That could be the best choice for some.

As discussed above, trusts with high levels of foreign income or those able to shelter their income from the SIFT tax may feel no pressure to change. But we predict few trusts will make this decision for the following reasons:

- Most businesses will require access to capital and only the most mature business can ignore this reality. The ability of a trust to access capital will depend upon its ability to generate and distribute cash in the most tax-efficient manner. While the SIFT tax will impare that ability, the impact must be assessed on a trust-by-trust basis.
- Market valuations for a high dividend-paying public company may exceed those for trusts. The universe of corporate investors and level of analyst coverage is simply much wider for corporations.

- The world, especially the tax world, is simply a better place for a corporation. Tax rules (e.g., reorganization rules) are more established and understood. The same could be said of issues relating to debt financing, governance, legal and accounting matters. Trusts can operate in a corporate world, but those who have done it understand the ongoing challenges related to the complex structure.

Resource and real estate trusts face a few other considerations.

### Oil and Gas

Similar to income trusts operating in other industry sectors, many oil and gas income trusts will likely determine that conversion to a corporate structure is the most attractive option for carrying on operations after 2010. Many have been, and will continue to be, hurt by the “normal growth” provisions. These provisions severely restrict the ability of oil and gas trusts to raise new capital to finance the acquisition or development of their underlying oil and gas reserves, which are subject to continuous depletion.

A few oil and gas trusts may conclude that retaining the trust structure after 2010, at least for a period, will be more beneficial than converting to a corporation. One or more of the following factors could lead to this decision:

- the existence of significant tax shelter in the form of “resource tax pools” and other tax deductions that would allow the trust to treat its cash distributions as a return of capital, and therefore tax-deferred, as opposed to income distributions, which would attract the SIFT tax;
- situations in which the trust owns mature oil and gas properties with a long-term reserve life, which would require relatively small amount of additional capital; and/or
- significant ownership of foreign oil and gas properties, income from which would not be subject to the SIFT tax.

### Real Estate

Real estate investment trusts (REITs) will be excluded from the SIFT tax if all of the asset and revenue conditions in the definition of “real estate investment trust” (the “REIT test”) are satisfied.

The REIT test restricts the types of assets that may be held and the types of revenue that may be earned by a REIT. To comply, many REITs will have to restructure their operations and activities in certain ways. Most REITs are expected to undertake any necessary reorganization in order to be able to maintain their trust status and continue to be treated as flow-through entities. REITs with sufficient shelter from capital cost allowance and interest expense may be able to delay reorganizing until after 2010.

REITs that operate hotels, retirement homes and nursing homes will not be able to satisfy the REIT test, because payments for the occupation of, use of, or right to use a room in a hotel or other similar lodging facility will not be characterized as “good” income for purposes of the REIT test. If it is not possible to restructure these REITs by separating the real estate from the operating activity, it is expected that they will convert to public companies, sell their assets and operations or be taken over. It is also possible that a REIT with these “off-side” activities could maintain its status as a trust for some time after 2010 if it has sufficient deductions to shelter its income.

## 2. Convert to a Public Company

A number of trusts have already taken steps to become public companies. Generally, this decision has been made to respond to a specific problem, such as the need to cut distributions, the need to access capital, or a high level of non-resident ownership. Before recommending a conversion transaction, trustees have to consider:

- fiduciary duties to unitholders who were promised cash distributions;
- the dividend-paying capacity of the corporation;
- the effect on the investor base and likely “churn”;
- tax ramifications to both resident and non-resident investors;

- effect on existing debt;
- effect on and need to restructure management compensation plans;
- viability as a public company (share float, analyst coverage); and
- cost of converting.

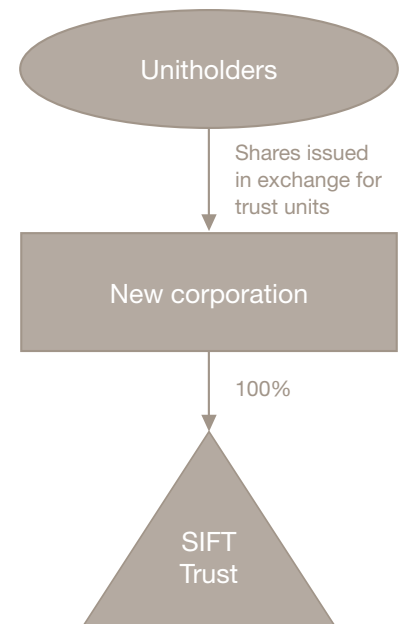
Conversion of a trust into a public company may be a viable option for the larger trusts. As a high dividend yielding public company, valuations and access to capital may be enhanced. Some simplification may also result from operating in corporate form.

Smaller trusts may not be viable as public companies. In fact, many were once public companies that were effectively “orphaned” in the market. They became trusts to enhance value and access capital.

The Department of Finance has indicated that rules will be enacted to permit a tax-deferred conversion of a trust into a public corporation. So far, no detailed rules have been released. These rules would not protect non-resident investors from tax ramifications in their home countries.

Some trusts have decided to proceed and have proposed that all trust units be transferred to a new public corporation in return for shares. This type of reorganization can be completed on a tax-deferred basis for the unitholders if tax elections are

filed in respect of the disposition of trust units for corporate shares. What is not generally possible is a tax-deferred liquidation of the trust into the new corporation. It is hoped that the Department of Finance will provide the necessary rules.



Another alternative is for the trust to transfer all of its assets to a newly formed corporate subsidiary. The shares of the subsidiary would then be distributed to the unitholders on the wind-up of the trust. Unfortunately, under current tax rules these steps would result in a realization of any gains inherent in the trust units held by the public.

### 3. Sell/Privatize

Smaller or mid-size trusts may not believe that either the status quo or conversion to a public company is optimal. The reasons include:

- The trust's small size may hurt valuation/analyst coverage.
- The trust faces an urgent need for capital to grow or refinance.
- The trust may be concerned by the complexity and costs related to public company status.
- The trust may be concerned that the business cannot sustain high levels of distributions.

These trusts should consider a sale or privatization transaction. Rather than waiting for it to happen, management and trustees should take an active role in the process and selection of a future owner/business partner. This process often starts with a strategic business assessment.

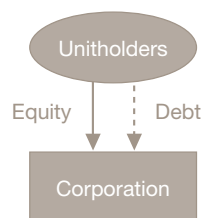
Mergers between smaller trusts are also likely to be a viable way to reach a size sufficient to make conversion to a public company optimal. Probable candidates are resource trusts, smaller REITs and business trusts in similar businesses. Particular caution is advised when trusts hope to solve business problems through a merger. Synergies, integration costs and cash flow/distribution effects must be considered.

### 4. IDS/Stapled Structure

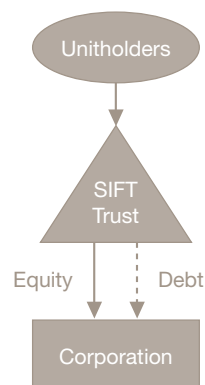
Income deposit securities (IDS) were developed as an alternative structure to an income trust. In its simplest form, an IDS unit is simply a share of a corporation and an interest-paying note of that corporation. Rather than trading as separate equity and debt securities, the two pieces are "clipped" together and traded as a unit.

The IDS structure simply eliminates the "trust" in a "trust over corporate" structure. For U.S. tax reasons, this direct holding of separate equity and debt securities was felt to be advantageous, so IDS structures were often, but not always, used in cross-border structures. They also allow for a majority of non-resident unitholders, something not permitted for an income trust.

IDS Structure



Trust Structure



As 2011 draws nearer, many trusts that hold debt of corporate subsidiaries may consider distributing that debt to the unitholders as a distribution of capital. The corporate debt would then be held directly by the public and interest payments would not be subject to SIFT tax. The debt could trade separately or could possibly be "clipped" to a trust unit. Another possibility would be for the trust to distribute the corporate debt and equity to the unitholders as a clipped unit. The viability of this alternative depends upon proposed trust reorganization rules that might permit tax-deferred liquidations of income trusts.

The effect of any restructuring on the unitholders must also be considered. For example, if the amount of debt

distributed exceeds the adjusted cost base of the unitholder's unit, a capital gain will result.

The SIFT tax proposals contained a warning that the Department of Finance might make further changes to address alternative structures designed to avoid corporate tax in the future. Whether an IDS structure, which is akin to a highly leveraged public company, would attract the attention of the Department of Finance is difficult to predict. Presumably the Department of Finance could place limits on the level of shareholder-held debt – a domestic thin capitalization rule. New Zealand has recently proposed rules that will deem the debt portion of a clipped or stapled unit to be equity for tax purposes. This would result in the loss of the corporate interest deduction and the interest itself would be treated as a dividend.

Widely held public debt is less likely to be considered offensive by the Department of Finance. However, corporate issuers must recognize the commercial differences between public debt and IDS debt. A holder of debt who has no equity stake is going to be more problematic to deal with if the company ever faces cash flow or restructuring issues.

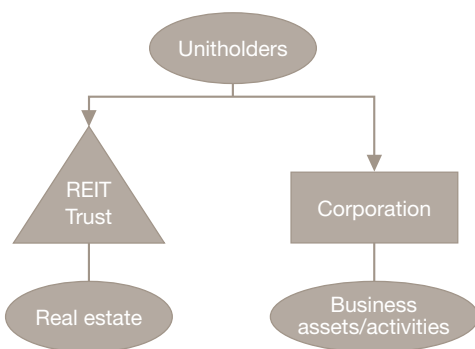
Interestingly, several of the companies that issued IDSs in past have recently made offers to eliminate the note portion of the IDS in exchange for a share. The offer to exchange is made by way of an issuance of rights providing for the exchange upon exercise. The exchange is conditional upon a minimum percentage (perhaps 66 2/3%) of the rights being exercised. The exchange is completed on a tax-deferred basis by filing a joint subsection 85(1) election. Aside from

this type of offer, there may be no way to force a conversion of the IDS notes into equity or otherwise eliminate them before their maturity date.

Presumably, the rationale for eliminating the IDS notes in most cases is to conserve cash flow within the corporation for expansion purposes. The fundamental question for income trust investors and managers is once again what is the most appropriate capital structure and distribution policy in light of the strategic objectives of the business?

## 5. Stapled REIT Structures

Certain REITs (e.g., those in the hotel or retirement home business) that will be unable to satisfy the REIT test for exemption from the SIFT tax may restructure themselves by separating their real estate from their operating activity. For example, a stapled structure often used in Australia is set out below. The REIT trust would qualify for exemption from the SIFT tax and would receive rent from the taxable corporation operating the business.



The challenges of moving to this type of structure are:

- the Canadian tax cost of transferring business operations into a new corporation and then transferring the corporate shares to the trust unitholders; and
- uncertainty as to the acceptability of this structure to the Department of Finance.

## 6. Master Limited Partnerships (MLPs)

Some trusts should consider the possibility of converting into a U.S. publicly traded partnership, more commonly referred to as Master Limited Partnerships or MLPs. MLPs have become increasingly attractive investment structures in the U.S. MLPs are similar to trusts in that the MLP earnings are not subject to tax at the entity level, but rather, the income is taxed only once at the unitholder level.

A Canadian trust that converts to a U.S. MLP must be sure to move its “mind and management” outside of Canada to avoid being subject to the SIFT regime. If the MLP is organized in the US, it must also meet certain gross income requirements. Otherwise the U.S. will tax the partnership as a corporation and the tax advantages of the MLP will be lost. For the gross income requirements to be met, at least 90% of the gross income must be from qualifying sources. Qualifying sources include interest, dividends, real property rents and certain active businesses in the mineral, natural resource or energy sectors. Given that qualifying income includes dividends and interest, MLPs do not have to be restricted to companies in the resource or energy sectors. Rather, it could include all businesses and be structured similar to current income trusts with operating subsidiaries.

Some of the possible advantages of an MLP are:

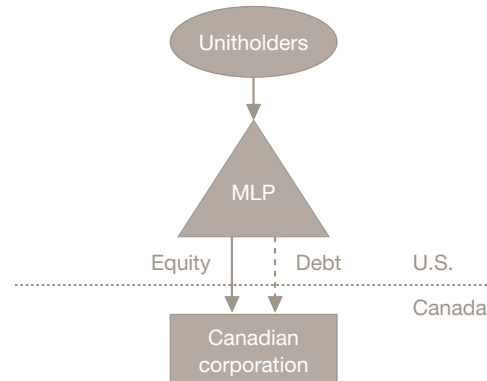
- lower cost of capital;
- access to a larger capital market (generally MLPs would be traded on a U.S. exchange);
- lower effective tax rates; and
- ability to grow without being subject to the SIFT growth limitations.

A major disadvantage of the structure is the cost of conversion. From a Canadian tax perspective, conversion into an MLP generally would be a taxable event only for Canadian unitholders. The tax impact in their own jurisdiction should also be considered.

In the context of Canadian income trusts, an MLP could be a viable alternative structure, especially for trusts that:

- currently have a significant number of US unitholders; or
- are trading at the low end of their historical range.

It could also be an attractive vehicle for trusts that operate in the energy or natural resource sector as the MLP would allow them to expand their business into the US. The following diagram shows a simplified structure of an MLP with investments in Canada.



# How PwC Can Help

All trusts have some decisions to make between now and 2011. Each of the issues described in this publication will affect income trusts differently depending on their unique situation. At the risk of oversimplification, we can categorize trusts in three different groups, depending upon whether their primary business objective is to achieve:

- rapid growth;
- organic growth; or
- stability.

Those facing rapid growth may feel especially constrained by the limits imposed by the Department of Finance and may have to take immediate action to access the required capital. That could include a conversion to a public company or even a sale or privatization transaction.

Trusts in more mature businesses may be able to grow organically and may not be especially constrained by the SIFT rules. For these businesses, waiting until 2010 to convert into a public company may be the best option. It maximizes the tax-efficiency of the trust structure for the longest period possible, and by 2010, the tax rules in respect of a conversion should be in place.

However, a large number of trusts can be grouped into the stability category. These trusts face challenges in maintaining distributions and perhaps are simply too small to operate as public entities. Because of their size, these trusts may have to address immediate financing and capital structure issues and a sale/privatization transaction may be their best or only option.

Because of these differences, it is very important that income trust investors and managers carefully consider their strategic options before making final decisions.

PwC has worked closely with many trusts in structuring their formation, raising additional capital, privatizations, insolvency and financing. In addition, we are auditors of 55 of the remaining 196 trusts and provide tax and other advisory services to many others.

The chart on the next page outlines a number of our advisory services for trusts organized using the three broad categories of trusts outlined above.

## Issues and implications by type of business objective

		Issues/options	Implications	PwC advisory services for trusts	Timing
Business objective	Rapid growth	<ul style="list-style-type: none"> <li>Identify/prioritize opportunities</li> <li>Obtain financing</li> <li>Implement efficiently</li> <li>Overcome structural impediments</li> </ul>	<ul style="list-style-type: none"> <li>SIFT growth guidelines</li> <li>Must resolve structural uncertainties immediately</li> <li>Must respond rapidly to avoid missing opportunities</li> </ul>	<ul style="list-style-type: none"> <li>Environmental assessment, including transaction activity and valuations</li> <li>Identifying acquisition categories and related targets</li> <li>Identifying capital requirements and optimizing capital structure</li> <li>Advising on legal/tax restructuring</li> <li>Transaction advisory services (diligence, valuation, structuring)</li> </ul>	Before 2010
	Organic growth	<ul style="list-style-type: none"> <li>Identify growth opportunities</li> <li>Obtain financing</li> <li>Assess impact of SIFT tax</li> <li>Determine post-2010 structure (status quo, public company, sale?)</li> </ul>	<ul style="list-style-type: none"> <li>Growth may offset SIFT tax cost</li> <li>Levels of past distributions</li> <li>Impact of alternative structures on equity value</li> </ul>	<ul style="list-style-type: none"> <li>High-level assessment of business plan</li> <li>Reviewing options for organic growth</li> <li>Quantifying impact of SIFT tax</li> <li>Identifying range of potential performance and implied effect on value</li> <li>Reviewing and advising on sale versus structure alternatives post-2010</li> <li>Fairness opinions</li> <li>Tax restructuring and tax election preparation</li> </ul>	Before 2011
	Achieve stability	<ul style="list-style-type: none"> <li>Reverse negative cashflow</li> <li>Remedy negative covenants</li> <li>Reduce distributions</li> <li>Refinance/sell/other</li> </ul>	<ul style="list-style-type: none"> <li>Possible insolvency</li> <li>Reduced unitholder value</li> <li>Possible need for structural changes</li> <li>Flow/allocation of taxable income</li> </ul>	<p><b>Financing issues:</b></p> <ul style="list-style-type: none"> <li>Assessing capital structure</li> <li>Identify potential financiers</li> <li>Recovery services if immediate action required</li> </ul> <p><b>Sale alternatives:</b></p> <ul style="list-style-type: none"> <li>Environmental assessment, including comparable transactions</li> <li>Identifying potential buyers</li> <li>Valuation analysis</li> <li>Impediment analysis and recommendations</li> <li>Tax restructuring</li> </ul>	Immediate

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